

THE FIRST KEY POLICY QUESTION ON DISABILITY

A background brief prepared by
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for the
Subcommittee on Disability and Retiree Health Care

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STAFF NOTE: This paper is being sent now so that at the February 29, 2000, meeting of the Subcommittee you can come prepared to enter into discussion on the first key policy question discussed in this paper. In the meantime, staff will continue to prepare for that meeting. Please do not hesitate to contact me at 444-3596 if you have any questions about this material or about the purpose of the disability portion of the February 29 meeting.

Beginning at the beginning

Before the Subcommittee gets any further down the road toward developing recommendations about public employee disability benefits, one key question must be answered. Is the Subcommittee prepared to recommend that an employer-sponsored disability plan be established apart from one or more of the current retirement plans? For the Subcommittee to answer this question, a review of how and why disability became an issue is in order.

Issue origin

The Subcommittee inherits an issue left unresolved by the last interim retirement committee and the 1999 Legislative Session, namely, how to provide disability benefits to public employees who may choose to join the new Defined Contribution (DC) retirement plan. This question arises because public employer-sponsored disability benefits have, traditionally and to date in Montana, been provided as an integral part of the employer-sponsored retirement plans, typically Defined Benefit (DB) plan types.

DB plans in general: Under a DB plan, employer and employee contributions are pooled in a pension trust fund, which is used to guarantee a set monthly benefit amount in an employee's retirement. If a member of the trust fund becomes disabled before reaching normal retirement age and/or years of service, DB-type plans typically provide that the member may receive a monthly disability retirement for life. The DB plan's trust fund underwrites the employer liability.

The PERS DB plan: The employer-sponsored retirement plan for more than 28,000 state, local, and non-teaching school district employees is the Public Employees' Retirement System (PERS). PERS is the largest of eight statewide public retirement plans. Under

PERS, to be eligible to receive a disability retirement benefit, a PERS member must have at least 5 years of membership service (i.e., be vested in the retirement plan). For purposes of this paper, it is only important to know that the amount of the disability benefit paid is based on the normal retirement formula. The PERS normal retirement formula is $1.76\% \times \text{final average salary} \times \text{years of service}$. Thus, the disability retirement benefit, because it is based on years of service and normal retirement at age 65 or 30 years of service, will provide larger benefits to older or longer-term employees. If a non-vested PERS member (that is, a member with less than 5 years of service) becomes disabled, that member is eligible only for a refund of employee contributions plus interest at the rate set by the retirement board (which is 5%).

A new DC plan is added to PERS: Until the passage of House Bill No. 79 last session, PERS was only a DB plan and the cost of disability benefits in PERS figured into the total cost of the retirement plan. However, HB 79 changed the landscape by adding a new DC plan type as an optional plan inside of PERS. Beginning by no later than July 1, 2002, all current and future members of PERS will be able to choose either the DB plan or the new DC plan. Under a DC plan, employer and employee contributions are not pooled. Instead, contributions are made to individual employee accounts. The benefit paid to an employee in retirement depends entirely on the total contributions made to the account and on how much the employee's chosen investments have earned. Thus, there is no pooled trust fund to underwrite the disability liabilities. Consequently, in order to address disability issues, employers sponsoring DC plans must decide whether to provide for a separate employer-sponsored disability plan. If the answer is yes, then the employer decides whether to contract with an insurance carrier or to establish a self-insured plan.

Absent some type of employer-sponsored disability plan, what *is* available to DC plan members in PERS? If a current or future PERS member chooses to join the new DC plan and becomes disabled, the member would have only the member's individual DC plan account balance. For a non-vested DC plan member (i.e., a member with less than 5 years of service), the member's account balance will consist only of the member's own contributions and the investment earnings on those contributions. For a vested DC plan member (with 5 or more years of service) the member's account balance will include both the employee and employer contributions and all (employee and employer) investment earnings.

The key question: Should there be an employer-sponsored disability plan that is separate from what is provided through the retirement plans now?

As noted at the outset, to effectively move forward in addressing public employee disability issues, the first question the Subcommittee must answer is: *Should there be an employer-sponsored disability plan that would cover employees in a manner that is separate from what is available now through their retirement plans (keeping in mind that this question arises from the situation of employees who will be joining the new PERS DC plan)?*

The research and testimony requested by the Subcommittee should, therefore, be focused on what information is needed in order to answer the above question. If the answer is no, then there is no need for further study. However, if the answer is yes, then several additional questions immediately arise.

If yes, then what? Some of the questions that arise if the Subcommittee answers "yes" are as follows:

- ▶ Should a separate disability plan be limited to DC plan members? Or, should there be a separate disability plan that covers all PERS members (DB and DC)? And, what about the seven other DB retirement plans?
- ▶ Should the disability plan be offered by contracting with an outside insurance provider, or be provided in-house through a self-insured plan arrangement?
- ▶ Should employer and/or employee participation be voluntary, or not?

(There are, of course, numerous other questions to be asked depending on the answers to each of the above questions.)

Back to the first question: However, unless or until the basic question of whether or not a separate disability plan should be provided as an employer-sponsored plan, the Subcommittee will not be able to answer any of the secondary questions.

The purpose of any disability plan

To assist the Subcommittee in its discussion of this first, most important question, it may be helpful for staff to review why an employer might, or might not, decide to offer a disability plan. In an attempt to stay brief and to the point, what follows is simply a listing of the *whys* and *why nots* of an employer-sponsored disability plan. First, a caveat--staff has not attempted to conduct the in-depth research and analysis required to adequately document, support, or dispute any of the following statements. Rather, what is offered is a staff synopsis of basic arguments taken from readily-available research.

Why is some type of disability benefit important?

- ▶ Statistics compiled by disability insurance providers indicate that:
 - people in their 30s are three times more likely to suffer a disability lasting three months or longer than they are likely to die;
 - nearly 33% of the total population will suffer a serious disability between the ages of 35 and 65;
 - the average disability will last more than 5 years, and for 30% of those disabled, the disability will persist for life;
 - the probability of disability i.e., the risk and therefore the cost of disability

insurance, increases with age; and the probability increases at a faster rate the older a person becomes.

- ▶ The ability to earn a living is a person's most valuable asset and when disability occurs, not only is a person's future earning potential lost, so is the person's ability to save for retirement.
- ▶ A wage-earner's disability is a financial crisis not only to the wage-earner, but to the wage-earner's family, dependents, and responsible care providers (and, for government a provider of public assistance).
- ▶ Other available resources, such as workers' compensation (which is limited to work-related disability), social security, and any state benefits are often inadequate to replace the loss of income and retirement savings.
- ▶ The younger a person is at the age of disability, the more resources are required to provide adequate income replacement.

Why might an employer sponsor a separate disability plan?

- ▶ Most employees, especially younger employees, do not think about the possibility or consequence of disability and do not take the initiative to seek supplemental disability insurance and the employer determines it has an interest in taking care of those employees.
- ▶ The cost for an individual employee to purchase disability insurance is significantly higher than the cost of participating in a group insurance plan where the risk is pooled. And, the employer finds added value in providing a disability insurance benefit that is less costly than increasing salaries.
- ▶ Providing a disability benefit through the employer's retirement plan adds cost to the retirement plan, but employees do not often perceive the benefit as an added value. Thus, the value to the employer is diminished. On the other hand, a separate plan is an additional benefit that more directly aids the employer's effort to recruit and retain employees (in turn, lowering the cost of high turnover or of having to increase salaries to hire qualified employees).
- ▶ Contributions to an employer-sponsored disability plan receives favorable tax treatment (e.g., contributions can be made with pre-tax dollars).

Why wouldn't an employer sponsor a separate disability plan?

- ▶ The employer may view the disability income available through other sources, such as workers' compensation and social security, in conjunction with the money available from the members' employer-sponsored retirement account (vested or not

vested) to be adequate to meet the employer's obligations.

- ▶ A separate disability plan requires additional resources and funding, which means higher employer costs
- ▶ The employer may determine that the added cost is not worth it, i.e., offering a separate disability plan does add value to the employer's benefit package.
- ▶ Employees can purchase disability coverage on an individual basis and tailored to meet their individual needs with available resources.

The bottom line

Again, before the Subcommittee can move forward effectively, it must carefully consider, discuss, and decide on (either by consensus or by vote) whether to recommend a separate employer-sponsored disability plan that would supplement what is now available through any of the public employee's retirement systems, but in particular for PERS members. Therefore, your questions (including requests for further staff research or requests for additional testimony from interested persons or for consulting services from experts in the field) should focus on getting the information you need in order for you to answer the first key policy question.